No. 10088.

IN THE

United States Circuit Court of Appeals

FOR THE NINTH CIRCUIT

CONSOLIDATED ROYALTIES, INC., a corporation, and C. B. CALLAHAN,

Appellants,

vs.

HARRY ASHTON, Trustee of the Estate of DEEP HOLE DRILLING CORPORATION, Bankrupt, *et al.*,

Appellees.

BRIEF OF APPELLEE.

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Preliminary Statement.

This brief is presented solely on behalf of Harry Ashton as trustee of the estate of Deep Hole Drilling Corporation, bankrupt.

Statement of the Case.

The statement of the case made by appellants fully and correctly states the facts, with the following exceptions:

The trustee does not have assets or funds sufficient to pay in full the claims of creditors arising from the drilling of said wells No. 1 and No. 2, or either of them. [Tr. p. 62.]

That, in addition to the $4000.00 in unpaid obligations incurred in drilling said Well No. 1, the substantial balance of provable obligations of the bankrupt estate are claims of Howard Supply Company and other claims resulting from the drilling of said well No. 2 subsequent to the acquisition by appellants of their 12% royalty interest in well No. 1. [Tr. p. 62.]

Simultaneously with the purchase of the 12% in well No. 1 the appellants acquired an option agreement from the bankrupt whereby they could purchase all or any part of the 15% royalty interest in a well to be drilled, designated as Deep Hole Well No. 2, and entered into a similar option agreement whereby they might purchase all or any part of a 15% royalty interest in a third well, to be drilled, of the bankrupt, designated as Deep Hole Well No. 3, said wells No. 2 and No. 3 to be located on nearby property. [Tr. pp. 60 and 47.]

That payments were made of all royalties accruing under the 12% in No. 1 well for the period ending September 1st, 1939. [Tr. p. 61.]

Summary of Argument.

Point 1.

The Bankruptcy Court had summary jurisdiction to determine the nature of the interest of appellants.

A. The property involved was in the actual or constructive possession of the court.

Point 2.

The theory of subordination of "investors" has not been modified or abrogated.

ARGUMENT.

POINT 1.

The Bankruptcy Court Had Summary Jurisdiction to Determine the Nature of the Interest of Appellants.

A. The oil wells and property upon which same were located were in the actual possession of the Bankruptcy Court as of the date of the filing of petition under Chapter XI. During this period the receiver and the trustee produced the oil, the proceeds from a portion of which are now in the hands of the Standard Oil Company of California which asserts no claim to such proceeds. The chief relief sought by the trustee was that the appellants' claim in and to the 12% interest in well No. 1, and the production therefrom, and proceeds thereof, were inferior and subordinate to the rights of the trustee and of the creditors. Jurisdiction to determine the foregoing is based upon the fact that actual possession of the subject matter of the controversy was in the Bankruptcy Court: *In the Matter of L. W. Baldwin*, 291, U. S. 610, 24 A. B. R., (N. S.) 487; *Taubel-Scott-Kitzmiller Co. etc. v. Fox*, 264 U. S. 426, 2 A. B. R. (N. S.) at 912.

The filing of the petition under chapter XI gave to the Bankruptcy Court the same jurisdiction as if a voluntary petition had been filed and an adjudication entered thereon as of the date of the filing of such petition under chapter XI, section 312 of the Bankruptcy Act; U. S. C., Title 11, Chap. 11, Sec. 712, which reads as follows:

> "Where not inconsistent with the provisions of this Chapter the jurisdiction, powers, and duties of the court shall be the same . . . (2) Where a petition is filed under Section 322 of this Act, as if a

voluntary petition for adjudication in bankrutpcy had been filed and a decree of adjudication had been entered at the time the petition under this Chapter was filed."

As was said in *In the Matter of Baldwin, supra:*

"Having possession, the court may not only issue all writs necessary to protect its possession from physical interference, but is entitled to determine all questions respecting same. . . . The jurisdiction in such cases is exclusive of the jurisdiction of other courts, although otherwise the controversy would be cognizable in them."

The appellant has discussed such cases as *Merritt v. Long,* 93 Fed. (2d) 257, and *Ramish, Inc. v. Laugharn,* 86 Fed. (2d) 686, each arising from the Ninth Circuit, on the proposition that summary proceedings will not lie as to appellants' property. We have no quarrel with the ruling in either of these cases, and answer by pointing out that in the instant case, the actual, physical possession of the oil well and of its operation were in the trustee in bankruptcy.

We believe that the question of the summary jurisdiction of the Bankruptcy Court is so well established that no further discussion of the cases cited by the appellant is necessary insofar as they relate to the question of jurisdiction. See *Street v. Pacific Indemnity Co.,* 61 Fed. (2d) 106; 22 A. B. R. (N. S.) 170.

POINT 2.

The Theory of Subordination of "Investors" Has Not Been Modified or Abrogated.

In 1932, in *In the Matter of Lathrap,* 61 Fed. (2d) 37, 22 A. B. R. (N.S.) 136, this court established the law to be that persons who invested moneys with an operating lessee, in exchange for a portion of oil to be produced by the lessee, had claims and rights which would be subordinate to the rights of creditors of the lessee in the event that he became bankrupt.

The first reason assigned by the court for this ruling was that, according to the weight of authority in California, title to oil or gas in place could not be transferred *in praesenti,* and that the purchaser of an interest from an operating lessee acquired no interest in the realty. This rule, we will freely concede and admit, has been changed by the courts of the State of California, and the rule now is that such purchasers do acquire an interest in the nature of real property.

The second reason assigned, however, by this court, *In the Matter of Lathrap,* for its ruling, is to be found in the following language:

> "Although percent holders are a recent product of corporate finance, and therefore, in a sense, *sui generis,* they bear a close analogy to preferred stockholders. . . .
>
> Whether or not the percent holders come under the technical classification of stockholders, they are,—like stockholders, partners or joint adventurers—

"investors," participants in the common enterprise. Had the bankrupt prospered and continued the operation of the oil well, these percent holders would have prospered with him, to an extent that their certificates did not even attempt to limit. Conversely, these same holders must be prepared to share in the bankrupt's misfortunes. There is no equity in their favor that places them in a position equal to that of general creditors, who sold merchandise or labor at only a normal profit. The creditors should not be the first to be sacrificed. It is the 'investors' who should be ready to take the bitter with the sweet."

The right of a Bankruptcy Court to thus subordinate "investors" has since been approved and reinforced by numerous rulings of the Supreme Court of the United States in such cases as *Pepper v. Litton,* 308 U. S. 295, and *Prudence Realization Corporation v. Geist,* Supreme Court of the United States, April 27, 1942, C. C. H. 53733.

In the former case, it is stated:

"In the exercise of equitable jurisdiction, the Bankruptcy Court has the power to sift the circumstances surrounding any claim to see that injustice or unfairness is not done in the administration of the bankrupt estate."

In the latter case it is stated:

"The Bankruptcy Act prescribed its own criteria for distribution to creditors in the interpretation and application of Federal statutes, Federal not local, law, applies. (Citing cases.) The court of bankruptcy is a court of equity to which the judicial administration of the bankrupt's estate is committed, and it is for that court—not without appropriate regard for rights

> acquired under rules of State law—to define and apply Federal law in determining the extent to which the inequitable conduct of a claimant in acquiring or asserting his claim in bankruptcy requires its subordination to other claims, which, in other respects, are in the same class."

Counsel has cited *Spier v. Lang*, 4 Cal. (2d) 711, 715, and *Theriot v. Plane* (C. C. A., 9th Cir.), decided March 31, 1942, to support appellants' contention that appellants are not within the *Lathrap* rule. Neither of these cases involved the right of the investor to obtain the return of his investment or to acquire the assets of an insolvent estate prior to payment of creditors.

In the instant case, it will be observed that the appellants not only acquired 12% in well No. 1, but, at the same time, acquired an option to purchase up to 15% each in two additional wells. It appears that the cost of drilling one of these additional wells makes up a preponderance of the claims presently provable.

We would further call attention of the court to the fact that *Spier v. Lang, supra*, refers to Section 2401 of the Civil Code of the State of California which reads as follows:

> "(4) The receipt by a person of a share in the profits of a business is *prima facie* evidence that he is a partner in the business, . . ."

May we point out that the appellants in this matter did receive as their share of the profits, the royalties which accrued up to September 1, 1939.

So far as the appellee is advised, there has been no abrogation of the rule of subordination laid down by the *Lathrap* decision.

On the other hand, the Supreme Court of the State of California, in *Schiffman v. Richfield Oil Co.*, 8 Cal. (2d) 211, at 224, in a decision rendered since *Callahan v. Martin, supra,* speaks with some askance upon the right of percent holders when it says:

> "If the effect of the percentage assignments was to create an undivided interest in the assignees in the leasehold estate, that is, in the right of profit to drill for and produce oil, notwithstanding it was understood that the lessees should retain exclusive management of the production enterprise, then as to such assignees the lessees are operating the well as their agents, or in some representative capacity. If the lessees are thus operating the well, the problem suggests itself as to the personal liability to third persons of the percentage assignees for debts and liabilities of the production enterprise. No question as to such liability is involved in the instant case."

Wherefore, appellee respectfully submits:

1. That the Bankruptcy Court had summary jurisdiction to determine the matters involved herein.

2. That the decision and order arrived at by the Bankruptcy Court was correct.

Respectfully submitted,

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